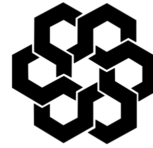

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **23 January 2008, London**

Project: **Earnings per Share**

Subject: **Sweep Issues (Agenda Paper 6B)**

PURPOSE OF THIS MEMORANDUM

1. The purpose of this memorandum is to address some potential issues that arose during the drafting of the FASB and IASB Exposure Draft, *Earnings per Share*. Specifically, the staff intends to discuss:

   a. The Boards' decision to exclude instruments that are measured at fair value with changes in fair value recognized in earnings each reporting period from the computation of diluted earnings per share (EPS)

   b. The meaning of "fair value" in the context of financial instruments (or contracts) within the scope of FASB Statement No. 123 (revised 2004), *Share-Based Payment*

   c. The Board's request for the staff to consider whether additional disclosures should be made for instruments subject to the *fair value method*.

2. The IASB staff is in the process of preparing a decision summary for the IASB (Agenda Paper 6A) that identifies the project objective, summarizes the IASB's and FASB's tentative decisions to amend the guidance in IAS 33, *Earnings per Share*, and FASB Statement No. 128, *Earnings per Share*, and asks the IASB to permit the IASB staff to begin drafting an exposure document. Since the FASB has already directed the FASB staff to begin drafting an exposure document based on the decisions reached to-date, the FASB staff will distribute the decision summary to the FASB separate from this memorandum as a reference[1] and will only ask the FASB the questions included in this memorandum.

Instruments That Can Be Settled in Cash or Shares and Are Measured at Fair Value with Changes in Fair Value Recognized in Earnings for the Reporting Period

3. The IASB and FASB previously decided that instruments (freestanding or separately accounted for as a component of a compound instrument) that can be settled in cash or shares and are measured at fair value with changes in fair value recognized in earnings for the reporting period should be excluded from the computation of diluted EPS (referred to as the fair value method). In drafting the preballot draft (which has not been distributed to Board members), the FASB staff had included what it believes was the IASB's and FASB's rationale for excluding these instruments from the computation of diluted EPS. Those reasons included the following:

    a. The changes in fair value recognized in earnings reflect the economic effect of these instruments on current shareholders. Excluding these instruments from the computation of EPS also satisfies the Board's objective of simplifying EPS.

    b. The inclusion of the carrying value of a liability that is measured at fair value with changes in fair value recognized in earnings in computing incremental shares under the modified treasury stock and reverse treasury stock methods will **always** be antidilutive, therefore why not eliminate these instruments from the computation of EPS?

4. The staff has determined that the second reason is not always true under the reverse treasury stock method, specifically when the fair value of the instrument is less than the intrinsic value of the option (or embedded option). Under the modified reverse treasury stock method, enough shares are hypothetically issued to raise enough proceeds (after

[1] As of the date of this memorandum, the IASB staff is finalizing the decision summary. The FASB staff anticipates distributing the decision summary to the FASB by January 11, 2008.

considering the fair value of the liability as an assumed proceed) to repurchase the shares subject to the contract. If the amount of shares assumed issued exceeds the shares assumed repurchased, then the contract would be dilutive. Because measuring a liability at fair value, as defined in FASB Statement No. 157, *Fair Value Measurements*, requires consideration of the entity's creditworthiness, it is possible for the fair value of an instrument to be less than its intrinsic value.[2] As a simple example:

> Assume an entity has net income of CU1,000 for the year and had 1,000 shares of common stock outstanding for the entire year. As of the beginning of the year, the entity sells 100 put options with an exercise price of CU10. At the end of the year, the entity is in bankruptcy and its end-of-period market price is CU1. Therefore, the intrinsic value of the put option is CU9. Due to the entity's reduced credit worthiness, the fair value of the liability is CU4. In computing diluted EPS under the modified reverse treasury stock method, the entity would assume issuance of 600 shares {[(100 options x CU10 exercise price) – (100 options x CU4 fair value)] ÷ CU1 end-of-period market price} to satisfy the put obligation. The difference between the 600 shares issued and the 100 shares received from satisfying the contract (a net increase of 500 shares) indicates that the contract would be included in diluted EPS, assuming the entity reports income from continuing operations, because it is dilutive.

5. In this example, inclusion of the fair value of the liability as assumed proceeds under the reverse treasury stock method would result in dilution. However, one could argue that because the entity is in financial distress, it would not be able to issue sufficient shares in the market to repurchase the shares subject to the written put option or that the holder would have exercised its option prior to the point where the instrument's fair value was significantly less than its intrinsic value. Therefore, the written put option may continue to be antidilutive.

6. The situation in which an instrument may have been dilutive under the treasury stock, reverse treasury stock, or if-converted methods is not limited to written put options. The fair value of an instrument may be subject to a multitude of different variables (for example, interest rates, credit risk, probabilities, and liquidity risk) that may result in the

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[2] IAS 39, *Recognition and Measurement*, establishes that fair value reflects the credit quality of the instrument and not the entity's own credit risk as in Statement 157. However, the IASB stated in its Discussion Paper, *Fair Value Measurement,* that the two concepts are consistent, as Statement 157 indicates that the effects of an entity's own credit risk may vary because of the terms of credit enhancement related to the liability.

fair value of the instrument being less than its intrinsic value. For example, the fair value of a convertible debt instrument is affected by changes in interest rates. Therefore, an increase in interest rates due to either the credit standing of the issuer or market conditions could result in the fair value of the convertible debt instrument being less than the intrinsic value of its embedded option (conversion value). Additionally, certain share-based payment awards (for example, stock appreciation rights) may not be recognized as a liability because the requisite service period is not expected to be rendered. However, because share-based payment awards are included in diluted EPS based on actual forfeitures and not estimated forfeitures, those shares would have been included in diluted EPS.

7. The staff believes that the IASB and FASB decided to adopt the fair value method because the changes in the fair value of those instruments reflect the economic effect of those instruments on current shareholders. That is, the changes in fair value reflect the benefits received or the detriments incurred by the current shareholders during the period and those changes already have been included in the numerator of an EPS calculation. The staff also believes that the IASB and FASB acknowledged that there may be circumstances when an instrument that would have been dilutive under the previous methods would be excluded from the denominator of the computation of diluted EPS because those instruments are recognized (or will be recognized at fair value upon satisfaction of a performance or service condition) at fair value with changes in fair value recognized in earnings. However, the IASB and FASB ultimately reasoned that excluding those instruments from diluted EPS represents a more realistic picture of the effect of those instruments on current shareholders because it does not assume one or more hypothetical transactions (for example, the treasury stock method assumes the exercise of all in-the-money options and the subsequent repurchase of shares from the proceeds of those exercises) and it would simplify the computation of diluted EPS.

8. Given the examples in paragraphs 3-5 of this memorandum, the staff would like to confirm that the examples would not change the IASB's and FASB's view on the fair value method. If these examples change the view of Board members, then the staff believes that it will need to clarify that an entity would only exclude these instruments from the computation of diluted EPS when the fair value of the instrument is at least equal to its intrinsic value. If this clarification is made, then the staff also believes that

the IASB and FASB will need to further discuss whether a numerator adjustment is necessary for those instruments that are measured at fair value with changes in fair value recognized in earnings, but included in determining the denominator of EPS. This modification(s) would have the effect of reducing the simplicity that the staff intended through the use of the fair value method.

9. The staff believes that questions may arise about what fair value means in the context of share-based payment awards that are subject to IFRS 2, *Share-based Payment*, and Statement 123(R). Further, as indicated in paragraph 5 of this memorandum, there may be share-based payment awards that are not currently recognized as a liability because the requisite service period is not expected to be rendered. Therefore, the staff is proposing to clarify that a financial instrument or contract subject to IFRS 2 and Statement 123(R) that is recognized (or would be recognized upon satisfaction of a performance or service condition) as a liability and measured under that Statement's fair-value-based measurement approach would be considered to be recognized at fair value for purposes of applying the proposed Statement.

QUESTIONS FOR THE BOARDS

> **Question 1—*Do the examples provided above change your view that an entity should use the fair value method for instruments measured at fair value with changes in fair value recognized in earnings for the reporting period?***
>
> **Question 2—*Do you agree with the staff's proposed clarification of fair value for share-based payment awards subject to IFRS 2 and Statement 123(R)?***

Proposed Disclosure Requirements for Instruments Subject to the Fair Value Method

10. At the March 28, 2007, and July 25, 2007 Board meetings, some FASB members requested that the staff consider whether additional disclosures should be made for instruments subject to the fair value method. Specifically, some Board members were concerned that users would no longer have information about the gross shares that would be issued upon conversion of convertible debt that is recognized at fair value with changes in fair value recognized in earnings. The staff believes that a simple solution

would be to require an entity to disclose the number of shares potentially issuable upon conversion or exercise of these instruments that were excluded from the denominator of diluted EPS because they were subject to the fair value method. However, some would argue that this additional disclosure would be inconsistent with the principle underlying current disclosure requirements in IAS 33 and Statement 128 and duplicative with the disclosure requirements in FASB Statement No. 129, *Disclosure of Information about Capital Structure*. First, the staff notes that projecting future share issuances is not an objective of diluted EPS. Rather, the objective of diluted EPS is to measure the performance of an entity over the reporting period. Second, while paragraph 70(c) of IAS 33 and 40(c) of Statement 128 require disclosure of securities that were excluded from the computation of diluted EPS because the effect would have been antidilutive for the period presented, the principle underlying that disclosure is that those securities could potentially dilute basic EPS in the future. That principle would not hold true for instruments subject to the fair value method because the dilutive effect of those instruments have already been reflected in the numerator of the diluted EPS computation for the period presented. Finally, some believe that the information that would be included in this additional disclosure (that is, the gross number of shares potentially issuable upon conversion or exercise) is already required by Statement 129.

11. The staff would like to highlight that the above proposed disclosure would only provide information about the number of shares that were excluded from the denominator of diluted EPS because the effect of those instruments have been reflected in the numerator. The proposed disclosure would not require an entity to disclose the numerator impact of instruments subject to the fair value method. This is particularly important in the context of participating securities subject to the fair value method whereby earnings would have been allocated to the participating security under the two-class method, but will now be entirely attributable to the common shareholders. The staff does not believe that a modification to the proposed disclosure is warranted because the principle behind the fair value method is that the effect of certain instruments on common shareholders has already been reflected in the numerator. That is, the allocation of earnings to the participating security has already occurred through the fair value adjustments.

12. Some FASB members have suggested a requirement to disclose the gross number of shares potentially issuable upon exercise of instruments that would be subject to the

treasury stock method or reverse treasury stock method (that is, either equity instruments or liabilities that are NOT marked to market each reporting period). The current model of computing diluted EPS requires use of the incremental shares in the denominator. While there may be some that support a full disclosure of all gross shares that could be issued from potentially dilutive instruments (dilutive and antidilutive), the staff believes, and the FASB agreed at the March 28, 2007, and July 25, 2007 Board meetings, that such a robust disclosure requirement would not be within the scope of the short-term convergence project.

QUESTION FOR THE BOARDS

Question 3: ***Do the Boards want to require an entity to disclose the number of shares potentially issuable upon conversion or exercise of instruments that were excluded from the denominator of diluted EPS because they were subject to the fair value method?***